

DESCRIPTION OF BILLS
(S. 2283, S. 2321, AND S. 2418)
RELATING TO
TAX TREATMENT OF FOREIGN
EARNED INCOME
SCHEDULED FOR A HEARING
BEFORE THE
SUBCOMMITTEE ON TAXATION AND
DEBT MANAGEMENT GENERALLY
OF THE
COMMITTEE ON FINANCE
ON JUNE 26, 1980

PREPARED FOR THE USE OF THE
COMMITTEE ON FINANCE
BY THE STAFF OF THE
JOINT COMMITTEE ON TAXATION



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INTRODUCTION

This pamphlet provides a description of three Senate bills (S. 2283, S. 2321, and S. 2418) which are scheduled for a public hearing on June 26, 1980, by the Senate Finance Subcommittee on Taxation and Debt Management Generally. The bills relate to the tax treatment of foreign earned income of individuals.

The first part of the pamphlet is a summary. This is followed by a description of the bills, including a discussion of present law, issues involved, an explanation of the provisions of the bills, effective dates and estimated revenue effects.

(1)

I. SUMMARY

Under the Foreign Earned Income Act of 1978, Americans working abroad generally are eligible for deductions intended to reflect the excess costs of living abroad. Employees in camps in hardship areas may in the alternative elect to exclude \$20,000 from income. Prior to the 1978 Act, Americans working abroad generally could exclude \$20,000 (or, in some cases, \$25,000) from foreign earned income.

Under S. 2283 (Senator Chafee), present law would be replaced with an annual exclusion of \$50,000 (\$65,000 in some cases) and a deduction for foreign housing. S. 2321 (Senator Jepsen) would exclude foreign earned income entirely. S. 2418 (Senator Bentsen) would replace present law with a \$60,000 exclusion and a deduction for excess foreign housing costs.

(3)

II. DESCRIPTION OF THE BILLS

A. Present Law

Law prior to the Foreign Earned Income Act of 1978

United States citizens and residents are generally taxed by the United States on their worldwide income with the allowance of a foreign tax credit for foreign taxes paid. However, for years prior to 1978, U.S. citizens working abroad could exclude up to \$20,000 of earned income a year if they were present in a foreign country for 17 out of 18 months or they were *bona fide* residents of a foreign country for a period which included an entire taxable year (Code sec. 911). In the case of individuals who had been *bona fide* residents of foreign countries for three years or more, the exclusion was increased to \$25,000 of earned income. In addition, under the law prior to 1978, foreign taxes paid on the excluded income were creditable against the U.S. tax on any foreign income above the \$20,000 (or \$25,000) limit.

The Tax Reform Act of 1976 would generally have reduced the earned income exclusion for individuals working abroad to \$15,000 per year. However, the Act would have retained a \$20,000 exclusion for employees of domestic charitable organizations. In addition, the Act would have made certain modifications in the computation of the exclusion.

These amendments made by the 1976 Act never went into general effect because the Foreign Earned Income Act of 1978 generally replaced the section 911 earned income exclusion for years beginning after December 31, 1977, with a new system of itemized deductions for the excess costs of working overseas. However, taxpayers were permitted to elect for 1978 to be taxed under the new provisions or under the Tax Reform Act of 1976.

Foreign Earned Income Act of 1978

The Foreign Earned Income Act of 1978 generally replaces the section 911 earned income exclusion for years beginning after December 31, 1977, with a new system of itemized deductions for the excess costs of working overseas. The basic eligibility requirements for the deduction are generally the same as for the prior earned income exclusion.

The new excess living cost deduction (new Code sec. 913) consists of separate elements for the general cost of living, housing, education, and home leave costs. The cost-of-living element of the deduction is generally the amount by which the cost of living in the taxpayer's foreign tax home exceeds the cost of living in the highest cost metropolitan area in the continental United States (other than Alaska). The deduction is based on the spendable income of a person paid the salary of a Federal employee at grade level GS-14, step 1, regardless of the taxpayer's actual income. The housing element is the excess of the taxpayer's reasonable housing expenses over his base housing amount

(generally one-sixth of his net earned income). The education deduction is generally the reasonable schooling expenses for the education of the taxpayer's dependents at the elementary and secondary levels. The deduction for annual home leave consists of the reasonable cost of coach airfare transportation for the taxpayer, his spouse, and his dependents from his tax home outside the United States to his most recent place of residence within the United States.

In addition, taxpayers living and working in certain hardship areas are allowed a special \$5,000 deduction in order to compensate them for the hardships involved and to encourage U.S. citizens to accept employment in these areas. For this purpose, hardship areas are generally those designated by the State Department as hardship posts where the hardship post allowance paid government employees is 15 percent or more of their base pay.

As an exception to these new rules, the Act permits employees who reside in camps in hardship areas to elect to claim a \$20,000 earned income exclusion (under Code sec. 911) in lieu of the new excess living cost and hardship area deductions. No foreign tax credit would be allowed for foreign taxes attributable to the excluded amount. For taxpayers electing the exclusion, the camp would be treated as the employer's business premises so that the exclusion for employer-provided meals and lodging can also be claimed (provided the other requirements of Code sec. 119 are satisfied).

The 1978 Act liberalizes the deduction for moving expenses for foreign job-related moves, increasing the dollar limitations applicable to temporary living expenses. The Act also extends up to four years while the taxpayer is working abroad the 18- or 24-month period for reinvestment of proceeds realized on the sale of a principal residence.

B. Issues

The issue is whether the provisions for the taxation of Americans working abroad should be modified to afford more generous relief. A related issue, if only part of the individual's foreign earned income is to be excluded, is the extent to which the relief should be tailored to the specific circumstances of the taxpayer or should be in the form of a flat dollar or formula amount.

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presented

C. Explanation of Provisions

1. S. 2283 (Senator Chafee): Partial exclusion for foreign earned income of individuals

Explanation of the bill

The bill would retain the eligibility standards of present law (the *bona fide* residence and presence tests). Individuals meeting these requirements generally could exclude foreign earned income attributable to the period of foreign residence or presence at an annual rate of \$50,000. If an individual had been a *bona fide* resident of a foreign country or countries for three years, the annual rate of exclusion would increase to \$65,000. As under present law, amounts paid by the United States or any of its agencies would not be excluded. The rules now in effect relating to the computation of the exclusion, and disallowing a credit or deduction for foreign taxes or expenses allocable to the excluded income, would be retained.

In addition to the exclusion described above, the individual would be allowed an exclusion for housing. The exclusion is equal to the greater of (1) the amount by which his housing *allowance* exceeds 20 percent of his earned income for the taxable year, or (2) the amount by which his housing *expenses* exceed 20 percent of his earned income for the taxable year. In both cases, earned income is determined without regard to the housing allowance he receives (if any).

The individual's "housing allowance" is defined as an amount paid to the individual by his employer which is designated by the employer as paid for the purpose of defraying the individual's housing costs during the period during which he is outside the United States, or foreign earned income in the form of the right to use property or facilities. However, the term does not include any amount paid by the United States or any of its agencies or any amount to the extent that it is lavish or extravagant under the circumstances.

The term "housing expenses" means the reasonable expenses paid or incurred during the taxable year by or on behalf of an individual for housing for the individual (and, if they reside with him, for his spouse and dependents) in a foreign country. The term includes expenses attributable to the housing (such as utilities and insurance), but does not include interest and taxes, which are separately deductible. The housing expenses of the individual's spouse and dependents may be excluded from income by him even if they do not live with him if his living conditions are dangerous, unhealthful, or otherwise adverse.

The general deduction for excess foreign living costs provided under present law (Code sec. 913) would be repealed.

Effective date

The bill generally would apply to taxable years beginning after December 31, 1979. However, taxpayers could elect to be taxed under prior law for taxable years beginning after December 31, 1977 but before January 1, 1980.

Revenue effect

It is estimated that this bill would reduce calendar year liability and fiscal year receipts as follows:

	(millions of dollars)					
	1980	1981	1982	1983	1984	1985
Calendar.....	407	440	475	513	554	559
Fiscal.....	(¹)	649	459	496	536	579

¹ Negligible.

2. S. 2321 (Senator Jepson) : Exemption for foreign earned income of individuals

Explanation of the bill

The bill would retain the eligibility standards of present law (the *bona fide* residence and presence tests). Individuals meeting these requirements could exclude the entire amount (except amounts paid by the United States or any of its agencies) of their foreign earned income attributable to services performed during the period of residence or presence. Taxes or expenses allocable to the excluded amounts would not be allowed as a credit or deduction. The deduction for excess foreign living costs of present law (Code sec. 913) would be repealed.

Effective date

The bill would apply to taxable years beginning after December 31, 1980.

Revenue effect

It is estimated that this bill would reduce calendar year liability and fiscal year receipts as follows:

	(millions of dollars)				
	1981	1982	1983	1984	1985
Calendar.....	508	676	677	731	789
Fiscal.....	279	573	654	707	763

(8)

3. S. 2418 (Mr. Bentsen): Partial exclusion for foreign earned income of individuals

Explanation of the bill

The bill would modify the eligibility standards of present law. The *bona fide* residence test would remain in its present form. However, an individual would also be eligible for the special provisions if he were present in a foreign country or countries for 330 days in any period of 12 consecutive months (rather than 510 days in any period of 18 consecutive months as under present law). Moreover, these minimum time periods could be waived with respect to Americans working abroad who could reasonably have been expected to meet those eligibility requirements, but who left the foreign country under conditions of war, civil unrest, or similar conditions which precluded the normal conduct of business.

Individuals meeting the eligibility requirements could exclude foreign earned income attributable to the period of residence or presence at an annual rate of \$60,000. As under present law, amounts paid by the United States or its agencies could not be excluded. The rules, now in effect relating to the computation of the exclusion, and disallowing a credit or deduction for foreign taxes or expenses allocable to the excluded income, would be retained.

In addition, individuals qualifying for the exclusion would be entitled to a deduction for qualified housing expenses. These are the excess of the individual's housing expenses over his base housing amount. The term "housing expenses" means the reasonable expenses paid or incurred during the taxable year by or on behalf of the individual for housing for the individual (and, if they reside with him, for his spouse and dependents) in a foreign country. The term includes expenses attributable to the housing (such as security, utilities, and insurance), but does not include interest and taxes, which are separately deductible. Housing expenses are not treated as reasonable to the extent they are lavish or extravagant under the circumstances.

The "base housing amount" is computed at an annual rate of 16 percent of the salary of an employee of the United States whose salary grade is step 1 of grade GS-14. (Currently, this salary is \$34,713, so the current base housing amount would be \$5,554.)

The present deduction for excess foreign living costs (Code sec. 913) would be repealed. However, the bill would retain the rule of present law that a hardship area camp is treated as the business premises of the employer, permitting (if other conditions are met) the exclusion from income of the value of meals and lodging.

Effective date

The bill would apply to taxable years beginning after December 31, 1979.

Revenue effect

It is estimated that this bill would reduce calendar year liability and fiscal year receipts as follows:

(millions of dollars)

	1980	1981	1982	1983	1984	1985
Calendar-----	440	475	513	554	598	646
Fiscal-----	(1)	701	496	536	578	624

¹ Negligible.